McKenna, Reginald

The international debt

New York

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FROM AN ADDRESS BY

The Rt. Hon. Reginald McKenna

▽

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AT THE

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New York, October 4, 1922

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THE FARMERS' LOAN AND TRUST COMPANY
NEW YORK CITY

The International Debt

A World Problem for Americans to Think About

THAT the prosperity of the United States is dependent upon the prosperity of other parts of the world; that we face continued disturbance of conditions favorable to healthy world trade; that these conditions with their consequent disastrous reactions upon us are likely to become worse rather than better unless certain necessary adjustments are made, and that the most important of these adjustments concern the international debt and the German reparations—these are things that have been repeated again and again in the past two years.

They have been reiterated by many leaders of financial and economic thought in the course of

the recent convention of the American Bankers' Association in New York.

Among the convention speakers was the Right Honorable Reginald McKenna, Chairman of the Joint City and Midland Bank of London. The essential parts of Mr. McKenna's address are republished herewith for the reason that what Mr. McKenna had to say was characterized by great clarity of expression and will help to establish an understanding of the problems to be solved.

JAMES H. PERKINS, *President.*

New York, October 11, 1922.

The International Debt

FROM AN ADDRESS BY

The Rt. Hon. Reginald McKenna

IN their report to the Reparation Commission, the Bankers' Committee which sat early this Summer in Paris laid stress upon the need to resume normal trade conditions between countries and to stabilize exchanges, and they came to the conclusion that neither of these aims could be accomplished without a definite settlement of the reparation and other international debts.

There will be general agreement that there is no matter of more deep concern to the world's trade at the present time than reparation payments and international debts, and I trust, therefore, you will not deem it out of place that I have chosen this subject for discussion.

First let us look at the magnitude of these international debts. The greatest of all is that

of Germany for reparations, a debt of which the United States declined to receive any share. The amount was not defined by the Treaty of Versailles, but subsequently by the London Ultimatum it was put at $32,000,000,000, at which amount it stands nominally today. Of the remaining debts the liability of France to the United States and Great Britain is $6,500,000,000, and of Italy to the same two countries $4,500,000,000. Russia owes these countries $3,500,000,000 and a further $1,000,000,000 to France. These are the principal debts, the others are all comparatively small in amount. Of the creditors of the European Continental Governments, England is the greatest.

We have no record in history of international claims of this magnitude. The indemnity exacted by Germany from France under the Treaty of Frankfort in 1871, in round figures $1,000,000,000, created the largest debt between Governments ever known until the recent war, and is the only precedent we have of a considerable international payment. It is of interest to recall how the liability was discharged. Payment of $150,000,000 was made

in gold and silver coin and in German banknotes and currency collected in France, and the balance in foreign bills, chiefly German currency bills.

How France Paid in 1871

The precise form in which the payment was made is, however, comparatively unimportant. For our present purpose the significant question is how France procured the means of payment. She was bound to acquire German marks or foreign currency exchangeable for marks, and to do so she had either to find German or other foreign buyers for such things as she had to sell, or to obtain foreign subscriptions to her loans. Very considerable sales were made of foreign securities owned by French nationals, the French loans were largely subscribed externally, and the export of French goods was so much increased that an average excess of imports of $65,000,000 a year in the four years 1868-71 was converted into an average excess of exports of $46,000,000 a year in the four subsequent years. By September, 1873, the whole indemnity was paid, and although France remained liable for

the loans she had issued, she was clear of any direct debt to the German Government, and indeed of all foreign debt payable in any but her own currency.

Here we have an example of a very considerable international debt rapidly paid off without any serious disorganization of the world's trade. What were the conditions which made this possible? The war had been short, and the amount of the indemnity was well within the capacity of France to pay. Her nationals held large blocks of foreign securities, which were realizable in foreign markets; her credit was good, which enabled her to obtain foreign subscriptions to her loans; and in her effort to increase her exports she was not hampered by high tariffs. She was driven off the gold standard and, although there was some decline in the value of the franc, the depreciation never exceeded 5 per cent., and, taking the whole period through, amounted to barely more than 1 per cent. But of the several factors in the French ability to pay, the most important lay in her accumulated reserve of wealth, the foreign securities owned by her nationals.

It is interesting to note the industrial condition of France at that time. Employment was extremely active and production was on a great scale. She had to meet her external liabilities, which compelled her to increase her sales in foreign markets, and she did so notwithstanding the competition of other nations. The improved standard of efficiency in production which was thereby forced upon her endured long after the period of the indemnity.

Effect Upon Germany

In Germany, on the other hand, there was a very different experience. The receipt of a large amount of gold and silver had, with other causes then in operation, a serious effect upon German internal prices, which rose rapidly. In 1872 there was a brief trade and financial boom, followed in the ensuing year by a crisis which was the beginning of a period of depression.

It would not be correct to say that the trade conditions in Germany were entirely due to the payment of the French indemnity, but undoubtedly it was a contributory cause of material importance. The comparative prosper-

ity in France and depression in Germany are remarkable and give color to the story that Bismarck, in commenting upon the state of the two countries, declared that the next time he defeated France he would insist on paying an indemnity.

Such is the only precedent we have for the payment of a great international debt. The figures we have to deal with today are on a far larger scale than the indemnity exacted from France fifty years ago, but the problem in all essential particulars is the same. We have to discover the capacity of the debtors to pay and to consider the consequences of payment. As the indemnity demanded from Germany is much the greatest of the debts and is the one most urgently in need of a satisfactory settlement, I place it in the front of our discussion.

The first question is, what is Germany's capacity to pay? You are perhaps expecting that I am about to give you an inventory of Germany's natural resources and an estimate of her productive power. All this has been done many times and much industry has been displayed in the inquiry. I have no doubt that the experts who advised the signatories of the

Treaty of Versailles that Germany could pay $120,000,000,000 had made many careful calculations of this kind. But what we have to investigate is not Germany's capacity to produce, but her capacity to pay foreign debt.

I cannot help thinking that we have here the source of the error into which the Versailles experts seem to have fallen. Nobody has ever doubted Germany's immense power to produce, but production by itself is not enough. She must find a market for her exports, and the problem thus becomes one of determining the possible extension of German export trade. Nor is this the end. We must remember that an increase in her exports will only provide funds for reparations if there is no corresponding increase in imports. Payment for her indispensable imports must be the first charge upon the proceeds of her foreign sales, and it is only the balance, the exportable surplus, which is available for reparations.

Exportable Surplus

In speaking of a nation's exportable surplus we must not forget that other factors may contribute to it besides the balance of exports over

imports. Interest received from foreign investments and payment for external services, such as shipping, may be contributory factors. Before the war Germany possessed a very considerable exportable surplus derived from all three sources, but mainly from the interest on her foreign investments, which were probably worth not less than $5,500,000,000. As regards the surplus from the sale of her products and payment for services it is safe to say that it never exceeded $100,000,000 a year.

But what is her position today? Most of her foreign investments have gone. Some were sold during the war, others have been seized as enemy property by the Governments of the allied and associated powers, and most of what remains have lost their value, as in the case of the Russian investments. Her shipping has been largely confiscated, and she has been deprived of some of her most productive areas—Alsace-Lorraine, the Sarre Basin and the Polish provinces.

All the sources whence an exportable surplus might have been drawn have been greatly impaired, if not wholly destroyed. At no time was Germany's exportable surplus sufficient

to enable her to make the annual payments demanded under the London ultimatum; it is entirely out of the question that she could do so today.

But let us get a little nearer to the problem of Germany's present capacity to pay from the surplus sale of her production. According to a recent statement by the Chancellor of the Exchequer in the House of Commons she has paid money and delivered property altogether to the value of about $2,000,000,000. Of this amount $1,645,000,000 represented the value of ships, coal, other payments in kind, property in ceded territories and local payments to armies of occupation. The amount in cash has been only $375,000,000. And yet, with this comparatively small cash payment, observe what has happened.

The mark has declined to less than one-seventieth of the value it had when the obligation to pay was imposed upon Germany by the Treaty of Versailles. The means of payment has been found by the sale of marks. After this experience it is difficult to believe that Germany has any surplus at the present time from the export of her products.

Exports Barely Equal to Imports

There is a further consideration in support of this conclusion. It is beyond question that in the last three years Germany has made every effort to develop her external trade. The German workman, whose industry and efficiency are generally admitted, has been fully employed and the factories have been actively at work all over the country.

The decline in the mark, which at every stage has been much greater in the external than in the internal value, has afforded a very considerable advantage to the German exporter, so much so, indeed, that there is hardly anywhere a manufacturer, producing goods for export, who does not complain of German competition. Nevertheless the German trade figures show that the exports, long after the immediate deficiency in essential foreign commodities due to the war was made good, are still barely equal to the imports. The conclusion seems irresistible that Germany has no present capacity to obtain a surplus from the export of goods.

I am not sanguine enough to believe that those who think they can extract from Ger-

many enough money to enable them to meet the internal liabilities, which they themselves have incurred in restoring devastated areas, will be satisfied with the statement I have just made. At the recent reparation conference of the allied powers held in London, proposals were made of punitive measures to be taken with the object of compelling Germany to make immediate cash payments, a policy which could only have been advanced under the conviction that Germany really could pay.

For my part, I do not believe that it is within her power to do so, but let us suppose for a moment that she can. We have then to consider what the effect of this enforced payment would be upon international trade, and whether it would be to the advantage either of Germany's creditors as a whole or of the rest of the world.

If Germany could pay what is demanded of her, the only method of obtaining the money would be by increasing her exports. Now what are these exports to be?

She is essentially a manufacturing nation. Her foreign sale of raw materials is comparatively small. On balance she is obliged to im-

port food, and in consequence of the loss of a large part of her mineral lands she is compelled to import both iron ore and coal for the supply of her factories and furnaces. An increased exportable surplus could only be obtained by extending her sale of manufactured goods. To do this in the teeth of the competition of other manufacturing nations she must work longer hours for less wages, she must cut profits, she must reduce her imports to the indispensable minimum.

Effect of Competition

But her competitors will not consent to stand idle while they lose their trade. They will find themselves faced with growing unemployment and heavy trade losses. So far as German goods seek to invade their own domestic markets they may endeavor to exclude them by tariffs, but in order to retain their hold on neutral markets they too will be compelled to reduce wages and cut profits. And thus Germany's effort to extend her foreign trade must be confronted with the opposition of the whole manufacturing interest of the rest of the world, and could only be successfully countered by a general lowering of the standard of life.

I know it is frequently alleged that the collapse of the mark with the accompanying disorganization of the world's trade might have been avoided if the German Government had acted with firmness and good faith. It is said that Germany has intentionally depreciated her currency in order to induce her creditors to abandon their claims. We are told that her people are not adequately taxed, and that if they were subject to the burdens borne in some other countries, the Government would be able to meet its liabilities.

It is certainly true that in my own country far heavier taxation is levied than in Germany, but I am inclined to think we are overtaxed and that overtaxation so far from fostering cannot fail to depress national production. But whether I am right or wrong in that opinion, I fail to see how additional taxation can stimulate foreign trade and provide a large exportable surplus. The taxes would be paid in marks, and whether the marks are derived from avowed taxation or from concealed taxation through the use of the printing press, they are in neither case a currency which would be accepted in discharge of foreign liability.

In the actual condition of Germany a foreign sale of marks is an inevitable accompaniment of the payment of reparations. Except by such sale there does not appear to be any practicable method for the Government to obtain the necessary foreign currency other than by exacting it from exporters as a condition of their receiving an export license. But the exporter, who often has external obligations of his own to meet, does not want marks, but dollars or pounds sterling, as the case may be, and forthwith sells the marks paid him by the Government for the currency he needs. If we add to this regular sale in the course of business the further sale by Germans who mistrust the stability of their own currency, we have a sufficient explanation of the stupendous drop in marks.

What Germany Can Pay

Let me come back now to the question of what Germany can pay. Certainly she can pay something, though not in the form or under the conditions it is now sought to impose upon her.

Many Germans possess foreign assets, whether investments or balances in foreign

banks, and it would be a perfectly practicable proceeding for them to sell these assets to the German Government, who in turn could hand them over to the Reparation Commission. But it is an essential condition of such a transaction that the owners of the foreign assets should be willing to sell them; no Government in the present situation of Germany could force a compulsory sale. How then could this consent be obtained?

I have no doubt that if these assets could be sold for an assured profit the holders would be willing to dispose of them. It must be remembered that to a considerable extent they are the proceeds of sales of marks which have been flung by Germans on the foreign market under the well-founded apprehension that the pressure of reparation payments would rapidly depreciate their value. Relieve this pressure and the mark would immediately improve. It has still a far greater value in Germany than it has outside, and the German holders of foreign assets would have a clear advantage in selling them for marks to their Government.

It is impossible to give any precise estimate of the total value of these assets, but I believe

it would be safe to put them at not less than a billion dollars. Whatever the amount may be, however, Germany could pay it, provided the fall in the mark was arrested. More than that I do not think she has the ability to find, at any rate for some years, and it would be a condition of this payment that no more should be demanded of her for a long time to come.

I believe that, looking merely at the amount to be received, the creditors would gain by abandoning the attempt to obtain other money payments for a period of at least three years, and I am quite sure the world as a whole would be an immense gainer in the general stabilization of exchanges which would ensue upon an arrest of the fall in the mark.

Before I leave this part of my subject there is one observation I should like to make. I have no wish to minimize the just claims of the Allies against Germany, and I recognize the serious political difficulties which stand in the way of their abatement. But no solution of the reparation is possible unless political considerations are subordinated to economic facts.

What Germany can pay may not be a simple question, but it is a question capable of be-

ing answered. Unfortunately, the answer runs counter to popular hopes, popular passions, and, more formidable still, a popular sense of natural justice, which prescribes that the defeated enemy who planned the war should make good the damage suffered by the victors. And so no authoritative answer is given while Europe slides into ruin.

Accumulated Wealth Essential

I have dealt at length with the reparation problem in an endeavor to show that a nation, except in so far as it has an exportable surplus, can only pay foreign debt out of the wealth it has accumulated outside its own country. If we pass now to the other international debts we have to recognize that the general argument is equally applicable to them all. Have the debtors an exportable surplus and what are their foreign assets?

With regard to the latter question the only debtor possessing any large accumulation of such assets is England. Notwithstanding her immense sale of securities to the United States in the second and third years of the war, a sale which largely furnished the means of paying

for the goods of all kinds bought by the Allies, England still owns sufficient foreign securities to cover her debt to the United States two or three times over. But neither France nor Italy has similar reserves of wealth. . . .

How France Incurred Debt

During the war France developed an immense demand for goods of foreign production. As an increasing proportion of her man-power became engaged in her army, her capacity to supply herself was progressively reduced. She had no abundance of foreign securities, such as England had, with which to pay for her requirements, and she could obtain the war materials indispensable for the maintenance of the fight in no other way than by borrowing the money to pay for them.

Before the United States came into the war France had borrowed $1,000,000,000 from the British Government, and this amount was subsequently increased to over $2,500,000,000. The price of the goods bought by France was naturally high. Commodities produced to meet an urgent war can never be cheap. But France was obliged to have the goods, what-

ever the price, and a great stimulus was given to American and British trade.

Let us now reverse the process and imagine France paying off this debt. She could only do so by producing goods and exporting them in very large quantities, far in excess of normal trade demands. If the general trade organization of the world permitted of the absorption of this additional French output, I have no doubt that her industry would be capable of the effort necessary to enable her to pay interest and sinking fund on her debt. But would there be any unwillingness to receive the goods? Neither England nor any other country is prepared today to pay for and consume goods on an exceptional scale.

The immense demand created by the war has no parallel in peace. And yet how is France to pay unless an exceptional demand exists. The truth is that her debt is far too great in relation to ordinary international trade possibilities. It was incurred by the purchase of goods required in war at war prices. It could only be discharged by the transmission of goods not wanted in peace and sold at no less high prices.

We became accustomed in war to talk in billions. Our language was suited to the circumstances of the time, but, if we carry our minds back to 1914 and return to the ideas appropriate to peace conditions, we shall recognize at once that France has no trade surplus or reserves of accumulated and exportable wealth to enable her to meet her present external liabilities.

There are of course conceivable, though I trust improbable, conditions in which the French debt to us might be repaid. If we were at war and the call upon our men to line the trenches was such that many of our mines and factories had to close down and if France were at peace and at liberty to increase her output to the utmost of her capacity she might pour upon our shores war material and stores equal to the whole amount of her debt to us. But in what part of the globe is there a demand for this additional output in time of peace? The mere endeavor to extend her foreign sales to the necessary degree would disorganize the trade of the world. We have seen the painful effect of an enforced competition by Germany;

we should experience precisely the same results from a similar effort by France.

Only England Able to Pay

The inevitable conclusion is that these international debts are far too great for the capacity of any of the debtor countries except England. She alone in her accumulated foreign investments has adequate resources with which to discharge her liability to the United States. Of the others, France has the greatest resources, but they are, I believe, quite insufficient to meet her obligations. The whole subject requires a rational reconsideration by the creditors, who must keep steadily in view the immediate effect of the payment of these debts of the general trade of the world.

The creditor countries—America and England—will obtain greater advantage from trade prosperity, which will insure full employment in their factories and workshops, than they can ever receive from the precarious payment of these debts.

In the last two years we have had experience of the effect upon foreign trade of tumbling exchanges and broken-down credits, and

though the consequence may be more serious in England than in the United States, where foreign trade is comparatively only a small part of the total trade, they are still grave enough in the latter country also to warrant the fullest and most careful consideration.

It may be objected that my argument appears to lead to the unpalatable conclusion that no nation, unless it has accumulated resources in the form of foreign investments, can discharge external obligations to anything more than a comparatively small amount. This is an objection which goes to the very root of the question of international loans, and forces us to a consideration of the real meaning of an exportable surplus.

It seems to me that the most compact form in which I can present the case is by calling your attention to the experience of England as a creditor country. For over two centuries English capital has been lent to other countries. Year by year England produced more than she either consumed herself or could exchange for the products of other nations, and she could not obtain a market for the surplus unless she gave the purchaser a long credit.

Foreign loans and foreign issues of all kinds were taken up in England and the proceeds were spent in paying for the surplus production. British factories and workshops were kept in good employment, but it was a condition of their prosperity that a part of their output should be disposed of in this way.

Taking the aggregate of the transactions British creditors have received a good return on their investment, but the ability of the debtors to pay has been dependent, speaking generally, on the development of their country, being fostered by the receipt of further loans. If we take the whole field of British foreign investment we shall find that every year England has returned in loans more than she received in interest, and the balance of the world's indebtedness to her has been steadily growing.

From this view of loans made to foreign countries they might seem at first sight to be somewhat unremunerative. If the creditor has to go on lending in order to be paid the interest on previous loans, a bad debt would appear to be the only possible end to the business. But this is by no means the case. While this con-

tinuous lending has been true in the past in the aggregate of foreign loans, it is not necessarily true in any individual instance, nor does it follow that it will always be true of the loans as a whole.

In our experience as bankers it is not uncommon to see loans to corporations and firms justifiably increasing in amount. The borrower may show by the growth of his business and expanding turnover that such advances are thoroughly warranted, and in spite of his greater total of indebtedness his credit may be improving and his balance-sheet may disclose an increasing surplus. What is true of an individual or corporation may be true of a country, but on a larger scale and viewed over a much more extended period of time.

The Case of the United States

Take the case of your own country. The United States has been the greatest external borrower in history. You required foreign capital for your internal development and you took from England alone—I put it very low—not less than three billion dollars. I believe it is a much larger figure. It is estimated that at

the time of the outbreak of the war your external debt had become stationary in amount, and that your exportable surplus of commodities sufficed to pay the whole interest.

Repayment of the capital, however, would have been beyond your capacity for a very long period had it not been for the opportunity afforded by the war. As you know, there arose then an inexhaustible demand in Europe for American goods, which led to an immense increase in your exports. Payment for these exports was largely made out of the proceeds of the sale of the stocks and bonds held in England, and thus a capital liability which had been growing for over two centuries was almost entirely discharged in a few years.

Demand an Accompaniment of War

We see then that a debtor nation may in certain circumstances pay off its foreign debt with remarkable ease and rapidity. The indispensable condition for such rapid repayment is that there should be an extraordinary demand for its goods, a demand which is the natural accompaniment of war but does not exist in peace.

I cannot help thinking that there has been a general, though very natural, misunderstanding of the conditions under which international payments are made. In its present magnitude the subject is new. In the past we have been accustomed only to the discharge of comparatively small liabilities between nations, which has been effected partly by the remittance of gold and partly by an extension of export trade, facilitated by a fall in the exchange of the debtor country, and it is not easy for us now to free ourselves from the ideas we have formed in the course of our past experience. Mistaken opinions on these economic questions are not surprising, but they are causing grave disasters throughout the world. . . .

Postponement Desirable

To sum up: The conclusion to which I am driven is that Germany can only pay now whatever she may have in foreign balances together with such amount as she can realize by the sale of her remaining foreign securities; that this payment is only possible if all other demands are postponed for a definite period long enough to insure the stabilization of the

mark; and that future demands at the expiration of this period must be limited to the annual amount of Germany's exportable surplus at that time.

Further, that England has the capacity to pay to the United States interest and sinking fund on her debt; but that the other debtors are none of them in a position to meet more than a small part of their external liabilities, and in the existing conditions of Europe a definite postponement of any payment by them is desirable in the interests of all the parties. . . .

If I have become convinced that an attempt to enforce payment beyond the debtor's ability is injurious to the international trade of the whole world, lowers wages, reduces profits and is a direct cause of unemployment, the conclusion is founded solely on economic grounds and is uninfluenced by any political considerations or any regard to the moral obligations of the debtors. . . .

The fact that a debtor cannot pay does not of itself discharge the obligation. The debt may become the subject of negotiation and bargain by which, if the debtor obtains relief, the creditor may still recover some advantage

to which he may be justly entitled. But I conceive it to be the duty of bankers to help, so far as they can, in forming a sound public opinion upon the financial and commercial aspects of these international debts, and it is in pursuance of this duty that I have ventured to make these observations.

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